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Ask an Advisor: Managing risks of overexposure to single stocks

By Rob Burgess
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Welcome back to "Ask an Advisor," the advice column in which real financial professionals answer questions from real people. The topic can be anything in the world of finance, from retirement to taxes to wealth management — or even advice on advising.

Concentrated stock holdings carry higher risks of volatility and, in many cases, steep taxes. However, with employee stock purchase plans (ESPPs) being offered, they are a very real part of many clients' portfolios.

For help, this week's questioner turned to his fellow advisors. Here's what he wrote:

Dear advisors,

How do you manage the risks of overexposure to a single stock, particularly for clients with large holdings in their employer's stock?

Sincerely,

Jason Gilbert
Founder and managing partner
RGA Investment Advisors
Great Neck, New York

In response, advisors suggested setting up charitable planning to decrease exposure and reduce tax liability, being brutally honest with clients about the risks, frequent tax-loss harvesting, gradually diversifying the portfolio, limiting exposure to a single stock to no more than 5% of liquid net worth, considering exchange-traded funds and more.

Here are some of the responses we received to this week's question, edited lightly for clarity and length:

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Concentrating stock is a great way to get rich, but a lousy way is to stay rich

Chris Magaña, a strategic advisor and principal at IMS Capital Management in Portland, Oregon

We start conversations about concentrated company stock by being brutally

honest about risk. We paint a blunt picture of a "bad day" for them: You lose your job, your company stock drops by 75% and your industry is in a downturn, so future employment prospects are bleak. Think it's not realistic? If we zoom out far enough, we've seen it in finance, tech and every industry.

Evaluating how this "bad day" could impact your life, your family's security and your plans is crucial. For a single 20-something with significant savings, the answer may be to let the concentration grow. However, this is an unacceptable risk for a 70-year-old primary breadwinner about to retire. The truth is, there's no one-size-fits-all solution for concentrated employer stock positions. It always boils down to this fundamental question: How does the "bad day" impact your life, family security and future?

We've all seen massive fortunes amassed by Musk, Buffet, Gates and Bezos by concentrating wealth. Assume you aren't them, and your results will be vastly different. The takeaway is that concentrating stock is a great way to get rich, but a lousy way is to stay rich.
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Several options to consider
Samuel E. Wagner, founder of WealthGuides in Indianapolis

If you're afraid to sell the stock because of outsized capital gains, consider harvesting losses from other positions in your taxable brokerage account. Offsetting those gains can make it more appealing to de-concentrate because you won't be getting hit so hard on taxes.

Consider an exchange fund. It's a pooled investment fund that gives individuals with concentrated stock the ability to contribute their stock positions to the fund and receive a proportional share of the more diversified fund.

Consider a put option. Put options are a contract that you can purchase that gives you the ability to sell your shares at a higher price if they experience a market drop during a set period of time. You have to keep purchasing the puts because the contracts expire over time but it gives you a safety net from a free-fall in the price of your company stock.

Consider gifts to charities. If you're already charitable or want to be charitable, you can give shares to a charity for the value of the shares. It's more tax efficient since you don't have to sell the shares and give the cash to the charity. And there is no guilt in passing the tax burden to the charity because 501(c)3s don't pay taxes on capital gains.

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Consider frequent tax-loss harvesting
David Flores Wilson, the managing partner of Sincerus Advisory in New York

The optimal way to manage single stock exposure ultimately depends on what the client's goals are, whether it's getting liquidity from the position, hedging out the downside risk, diversifying the position, minimizing taxes or a combination thereof.

Once a position is too large due to equity compensation, there are some immediate steps that probably make sense so that the investor doesn't compound the stock concentration issue further. The investor should immediately consider discontinuing dividend reinvestment, ceasing further investments through their employee stock purchase plan (ESPP) and systematically selling newly vested restricted stock units (RSUs).

To manage the large capital gain, investors should consider frequently tax-loss harvesting all other areas of their portfolio to build up capital losses that can be netted against future capital gains from the concentrated stock position.

The investor should consider periodic sales that spread the capital gain over different tax periods, which potentially would get them into lower capital gains brackets or avoid the net investment income tax (NIIT).

For qualified purchasers with a large concentrated position and a long-term time horizon, investors may want to consider an exchange fund. They could exchange their shares into an interest in a fund to receive immediate diversification, although they wouldn't be able to sell the interest for several years.

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Charitable planning can decrease exposure and reduce tax liability
Grant R. Maddox, founder of Hampton Park Financial Planning in Charleston, South Carolina

Applying company stock toward unique goals such as charitable planning can decrease exposure and reduce tax liability. Implementing a yearly schedule to gradually sell shares and diversify investments is another effective strategy for managing stock concentration over time.

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Gradually diversify the portfolio
Rick Vala, founding partner of VaMa Oak Wealth in Newtown, Pennsylvania

While concentrated stock positions can be a source of great wealth, managing the risk of overexposure, especially employer stock, can be an essential part of protecting your financial future. We focus on gradually diversifying your portfolio to reduce downside risk to one company while considering tax-efficient strategies. One method is through direct indexing which allows us to retain overall market exposure while simultaneously unwinding the concentrated position over time with little to no capital gains. Additionally, If you prefer to

retain a large holding, we can use hedging techniques like options and stop losses to protect against downside risk. Our approach is designed to reduce risk while respecting each client's situation and outlook.

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Avoid tax implications by spacing out diversification
Romy A. Pickron, founder and CEO of Asset Achievers in Dallas

To manage the risk of overexposure to a single stock, particularly employer stock, I often recommend a gradual sales strategy. By selling off small portions of the stock over time, clients can diversify their investments without triggering significant tax implications all at once. This approach also allows flexibility to adjust to market changes and reduces the emotional impact of parting with a large stock position.

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Tailor solutions to a client's situation and goals
Jirayr Kembikian, co-founder and managing director of Citrine Capital in San Francisco

Managing stock concentration risk can involve several diversification strategies. One common approach is to simply sell at least some of your shares. This is the cleanest and easiest plan to implement, but this may trigger capital gains taxes.

If you are already charitably inclined, you can donate your appreciated shares to either a charity or family, or both. Doing so may offer tax deductions or estate tax reductions.

Using options strategies is another consideration to hedge your downside risk. Another option is to participate in an exchange fund, which allows you to swap your concentrated stock for shares in a diversified portfolio. An exchange fund reduces stock concentration risk while also deferring taxes.

Each of these strategies have their own financial, tax and legal implications. It's recommended to consult with a financial planner experienced in stock concentration strategies to ensure they're appropriate for your situation and goals.

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Limit exposure to a single stock to no more than 5% of liquid net worth
Eric Roberge, founder and CEO of Beyond Your Hammock in Boston

A majority of our clients have equity compensation that, when left unmanaged, will create big concentrated positions in the client's company stock. In most cases, we advise clients to sell grants of equity-like RSUs as they vest and

reinvest the proceeds — net of what they need to set aside to pay taxes later — into a globally diversified portfolio to ensure they're avoiding the risk and volatility that comes with holding a concentrated position. For eligible clients, we will also help them set up 10b5-1 plans to help automate the process of regularly selling shares on a rules-based system that removes the potential for human error, which is most often forgetting to sell vested shares or hesitating to do so for emotional reasons.

We're not against clients holding single stocks, and many do for various reasons. But the guideline we put around this, to help mitigate risk and avoid unnecessary losses, is to limit exposure to a single stock to no more than 5% of liquid net worth. This way, the client can explore outside of our standard recommendation of a globally diversified portfolio, but without taking on risks that they could not recover from.